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The Debt Trap

> **"There is this grand distinction between an individual borrower and a borrowing government. In general, the former borrows and generates capital for the purpose of beneficial employment; the latter for the purpose of barren consumption and expenditure."**
>
> ***A Treatise on Political Economy***
> **Jean Baptiste Say, 1887**

With a few brief words, Fed Chairman Alan Greenspan has managed to shock financial markets worldwide, yet the ultimate result of his musings about "irrational exuberance" on Wall Street has been another surge in U.S. stock and bond prices. Truly, it seems the Great Financial Bubble of the 1990s has entered the theater of the absurd!

In this letter, we explain why Mr. Greenspan's comments so badly backfired. In the grand casino that now constitutes the U.S. financial markets, any event, negative or positive, is viewed simply as another opportunity for short-term trading in the futures and options pits or in the vast over-the-counter derivatives markets. Small wonder, then, that Mr. Greenspan's note of caution was enough to trigger an immediate, violent correction.

But that wrenching move, in turn, left the market wrongly positioned for the next random piece of news, which happened to hint of economic weakness and low interest rates in both the United States and Japan. The equally predictable result: a volcanic reversal that quickly propelled the Dow back within reach of its November highs.

What are we to make of these increasingly volatile swings? Only that they confirm the validity of Mr. Greenspan's fears – and demonstrate the Fed's utter impotence in the face of them. To repeat our comment from an earlier letter: bubbles can be prevented, never cured. In our view, it is far too late for the Fed to do anything but prick the bubble before it collapses of its own accord from an even more wildly inflated level.

Either way, the collapse of the boom will spell catastrophe for the industrial economies, which already teeter on the brink of a dangerous deflationary spiral. After reviewing the public debt figures for the major countries, we see ominous signs that many already are caught in the "debt trap" – the late and usually final stage of chronic indebtedness in which the debtor's interest payments begin to exceed his new borrowings.

To us, such a state marks the inevitable, dismal end of the Keynesian stimulus policies of the 1970s and 1980s. As governments struggle to reign in compounding interest costs, primary budgets must be driven ever more ruthlessly into surplus, implying mounting fiscal drag on the real economies.

The dire consequences can be seen clearly in Europe, where complying with the Maastricht Treaty's limits on budget deficits has proven an intolerable economic burden. Japan, too, appears headed toward a future debt crisis, as it vainly struggles to reflate its depressed economy with liberal doses of government spending. In America, it is private consumers who now seem to have reached the limits of their excessive borrowing, while the U.S. government must rely on the forbearance of its foreign central bank creditors to avoid its own debt debacle.

Concerning these "irrational" excesses, Mr. Greenspan no doubt will maintain a discrete silence. But we think they almost certainly will darken the financial and economic landscape in the new year now dawning.

The big escalation in debt relative to GDP began in the early 1980s, as global inflation rates decelerated. For the EC, the average debt-to-GDP ratio surged during the decade from 42.5% to 58.5%. But what followed eclipsed even the prior debt excesses. In blatant mockery of the Maastricht Treaty, which stipulated fiscal restraint, the average debt-to-GDP ratio in the EU rocketed with record speed in the first half of the 1990s, reaching 78.2% in 1995. In other words, debt rose 20% of GDP in just five years, after rising a mere 16% in the preceding ten years.

What has so stupendously ravaged public finances in Europe? Basically, there has been one chief reason: sluggish economic growth, including near recession in 1991-93 and a subpar recovery in 1994-96. This abysmal growth performance drastically curbed tax revenues while boosting government welfare and transfer payments.

In measuring the effects of rampant budget deficits on the economies and inflation rates of the industrial countries, we observe three distinctly different phases, roughly coinciding with the past three decades.

The decade of the 1970s was unique in that a drastic loosening of fiscal policies had its corollary in utterly loose monetary policies, as reflected in negative real interest rates, bursting money and credit growth, and exploding inflation. Effectively, soaring budget deficits were fully monetized if not overmonetized. Money took flight into real assets, whose prices skyrocketed. Though government debt tripled and quadrupled in some countries, it still fell in relation to GDP, as debts were cancelled out by the even faster rise in inflation and nominal GDP. Thus, in Britain, for example, the ratio of government debt to GDP plunged from 80.3% in 1970 to 54.3% in 1980.

In the 1980s, an entirely different scenario developed. The decisive new feature was the general reversal in monetary policy. While fiscal looseness continued apace, central banks pulled hard on the brakes to confront double-digit inflation. Everywhere, deficit monetization was stopped or dramatically reduced. As inflation rates slowed sharply, the large budget deficits began to surface in rapidly increasing ratios of government debt to income or GDP. In the United States, one of the worst sinners in this decade, the ratio more than doubled, to 70% of GDP.

What we see unfolding in the 1990s is the third and inevitable final stage of the prolonged global borrowing binge, where the rampant debt inflation of the past is translated into the debt deflation of the present and the future. The salient point to see is that in the industrial countries virtually all new government borrowing, and more, now is soaked up by interest payments. Just to prevent an explosive rise in their indebtedness, governments must make deeper and deeper cuts in non-interest spending. In this way, overindebtedness ultimately turns into deflation.

COMPOUND INTEREST – THE GREAT STRANGLER

In short, all EU governments now are caught in the debt trap. At its root is a familiar and predictable process: the relentless annual compounding of unpaid interest bills that are added to loan principal. But few people seem to be aware of the enormous dynamics inherent in this process. Think about this: A loan bearing a 6% interest rate doubles every 11 years, which implies a quadrupling in 22 years. At 9% interest, the debt doubles in just eight years and quadruples in little more than 15 years.

On average, the annual debt-service obligations of the EU governments now are running at 5.3% of GDP. This ratio has changed little over recent years because additions to the interest bill from rapidly growing debts have been offset by sharply lower market rates. These interest charges compare with the deficit target of 3% stipulated in the Maastricht Treaty. By far the worse case is Italy. Its total 1996 budget deficit is estimated at 6.3% of GDP, as against interest charges equal to 10.3% of GDP. In the U.S. case, a federal budget deficit of $164 billion in 1995 compared with interest payments of $232 billion.

It has become customary to measure the impact of fiscal policies on the economies in terms of the so-called primary balance. This aggregate focuses on the difference between debt-service costs and government operating

expenditures, subtracting the former from the latter. Fiscal drag – the contractive effect on economic growth from excessive indebtedness – principally begins to bite when interest charges overtake new borrowing, as reflected in reported deficits.

Underlying this concept are two assumptions: First, to the extent that the primary balance is in surplus, money for debt service has to be extracted from the taxpayers, or the recipients of government spending, reducing their purchasing power. Secondly, interest payments are qualitatively different from all other government expenditures. Their recipients are the economy's institutional and personal savers, who tend to reinvest their interest income in the financial markets.

Observing such a shift in financial flows, Keynes would have said governments are robbing the industrial circulation to benefit the financial circulation. Notwithstanding generally high budget deficits, the compound interest spiral slowly but inexorably is converting the fiscal excesses of the past into the fiscal drain of today and tomorrow.

What's more, the dynamics inherent in this debt-interest spiral spell worse to come for most countries. To stop the vicious cycle at this point would require truly heroic budget measures, for which neither Europe's politicians nor the public in most countries are prepared. Just preventing further rises in government budget deficits is requiring permanent, strong spending constraint. The borrower's plight and the inevitability of the exponential growth of his debts are so ghastly that it is hard to understand how virtually all governments could be snared in this way.

PRODUCTIVE VERSUS UNPRODUCTIVE DEBT

The main point of our discussion of the debt situation is that in the long run, excessive government borrowing essentially defeats itself simply through the exponential compounding of interest. Politicians and economists should have known this all along. Yet, unbelievably, nobody ever took the long-run costs into account. Considering that these excesses have lasted for just a little more than two decades, the long run actually was pretty short.

In trying to assess these debt problems, we should begin by drawing a crucial distinction between debt creation for unproductive purposes and debt creation for productive purposes. Or, to put it a bit differently: between debts that finance capital formation, yielding future income and boosting future economic growth, and debts used to finance current spending.

The runaway compound interest spiral that leads inexorably into the debt trap is implicit only in unproductive debt, incurred either by governments or consumers, or to debts from malinvestments. By contrast, money used or lent for productive investment is transformed into productive capital. This investment sets in motion a self-sustaining process of capital circulation. Capital assets, once created, are worn out, depreciated and, if profitable, reproduced. The original money is endlessly spent and re-spent for the production of goods and services, evoking an associated rise in employment and a perpetual flow of incomes. At same time, the debt-service burden is covered by the revenues yielded by the capital assets so created.

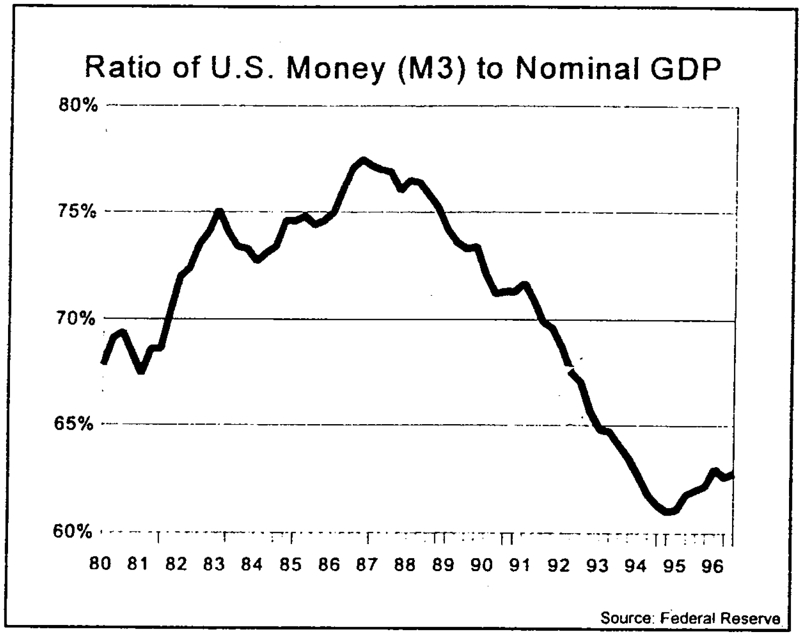
Let us compare this process of permanent capital circulation with what happens when governments and consumers incur debts in order to finance current expenditures. While this also creates instant demand for goods and services, it is only a one-time effect. There is no follow up – in contrast to the capital formation and capital circulation that results from debt-financed investment in plant and equipment. The one and only long-term legacy of this kind of borrowing is ever higher mountains of debt from the capitalization of unpaid interest. This edifice of debt represents the basis of our current prosperity.

In criticizing the American economist Irving Fisher's theory of debt deflation for its failure to distinguish between productive and unproductive debt, Joseph Schumpeter had this to say in his book *Business Cycles*: "The

only conclusion that really follows is that the credit system is so designed to serve the improvement of the productive apparatus and to punish any other use."

THE OTHER VICTIM: ECONOMIC GROWTH

Spiraling compound interest, though, is only part of the debt-trap story. Equally ominous is the corrosive impact on the long-term growth potential of the real economies. Debt-financed overexpansion of government spending essentially pulls resources away from productive investment. In all the industrial countries, the visible hallmarks have been shrinking shares of investment in GDP versus rising government and consumption shares. The proof of this also is there for all to see. Coincident with the explosion in public deficits and debts and the decline in capital formation, there has been a pronounced retardation of economic growth in the industrial countries..



Actually, the complete neglect of this distinction between productive and unproductive debt has been the great shortcoming of the current debate about credit and money creation. Yet it makes all the difference in terms of the impact of debt on the real economy. To quote Schumpeter again: "The effects of credit creation are not simply a matter of quantity, but mainly depend on the purposes which the credit creation serves and on the success that attends these purposes."

The normal, healthy pattern of the past was that credit creation went overwhelmingly into investment spending, both residential and nonresidential. Such spending also dominated the business cycle. Associated with big multiplier effects, all investment booms tended to give a temporary boost to inflation. While promoting economic growth in the long run, these powerful investment cycles were the source of inflation in the short run.

Essentially, however, the misguided growth-inhibiting policies of the past three decades progressively have retarded both the investment cycle and overall economic growth. Lower inflation is one of the side effects, and clearly a welcome one. Only we shouldn't interpret these low inflation rates as a sign of economic health. As we observed in our last letter, what they reflect in reality is the long-term impairment of the business cycle.

Indisputably, the financial markets are swamped with liquidity. At the same time, there is ferocious competition to lend, as reflected in the virtual collapse of interest-rate differentials worldwide. To all appearances, liquidity indeed is overabundant. Don't be fooled by this appearance: It is the deceptive liquidity of a bubble.

Generally speaking, what effectively has been propelling the financial markets is not excessive liquidity creation but rather a virtual collapse in the demand for money or liquidity – in short, the cash-is-trash syndrome. Effective liquidity growth, as measured by broad money, progressively is falling short of GDP growth in the United States, signalling shrinking liquidity. Money holdings relative to income are at their lowest levels in more than 20 years.

In other words, *de facto* liquidity is in very short supply. This has not had its customary restraining effect on the markets because the public's desire for liquidity has fallen even faster than its supply.

In particular, the money deluging the financial markets has come from two inordinate sources: a mass flight out of money balances and into securities, and tremendous financial leveraging, exploiting the unusually large national and international yield curves. Implicit in these processes is a rapid rise in money velocity.

WHAT CAUSES DEFLATION?

In pondering the possibility or probability of outright deflation, we focus separately on the real economies and on the financial markets. But our use of the term "deflation" may require some explanation about semantics. In the American tradition, the words inflation or deflation relate narrowly to changes in consumer and producer prices. We, however, use both terms in the European tradition, where they are applied in the widest sense to all kinds of economic and financial distortions, not only rising or falling price levels. Keynes, for example, spoke of profit deflation, income deflation or even capital deflation. The broad meaning of deflation, in short, is contraction, just as the broad meaning of inflation is overexpansion.

Yet with this brief explanation, we already have plunged right into the middle of the traditional debate between American and European economists about deflation and its causes. In the American view, deflations, like recessions, result from excessive monetary tightness. All that is needed to overcome them is easy money.

In the traditional European view, dominated by the Austrian school of economics, deflationary crises inevitably arise from the excesses and maladjustments that accumulated in the economies and their financial systems during the preceding inflationary booms. Consumer prices may not even be affected. Once the maladjustments have occurred, loose money is of little or no help. Restoring economic growth essentially requires a prolonged, painful readjustment process.

The outstanding example, which fully confirms this traditional European view, is the Japanese "bubble economy" of the late 1980s. This bubble reflected rampant inflation. It was visible everywhere: in a runaway credit expansion, in soaring asset prices and in tremendous overinvestment in commercial buildings, plants and equipment, which were revealed as massive malinvestments once the bubble burst. The one place, however, where rampant inflation made no appearance at all was in the overall level of consumer and producer prices.

Yasushi Mieno, the former head of the Bank of Japan, has had ample cause to regret the bank's misguided focus on consumer and producer prices. "Looking back, we now feel that we should have applied the brakes on the excessive boom much earlier," Mieno has said. "However, back in those days, as prices were not rising, it was difficult to obtain people's understanding for a policy aimed at achieving sustainable economic growth by monetary tightening." So far, the BoJ's rock-bottom interest rates have failed to restore self-sustaining economic growth.

Regarding inflation and the consequent growth-inhibiting maladjustments, Japan is the most extreme case in the world. But to a greater or lesser degree, such maladjustments have accumulated in all the industrial countries, with the result that we now see: feeble economic growth all around.

In Europe, the primary responsibility for the demise of growth clearly rests with the governments. In the 1970s and 1980s, the politicians ran riot in spending and borrowing. As a share of GDP, government spending surged from 37% to 50%, where it is now stuck. More than half of this increase went for exploding social transfers. As a mathematical rule, if one GDP share proliferates, at least one other must shrink. To be sure, this has been the investment share, which has fallen from an EU average of 23% to just 18% of GDP.

This alarming decline in the investment share started in the 1980s and has accelerated in the 1990s, affecting both building and equipment. In fact, we suspect net investment in plant and equipment virtually has disappeared

in Europe. In general, firms invest no more than their depreciations. Yet this is sufficient to deliver the productivity and production growth needed to meet prevailing growth expectations of around 2% per annum.

EUROPE ON THE BRINK OF DEFLATION

Europe's greatest blessing and its primary problem is the fact that its long-term trend in productivity growth is 2% per year, as against less than 1% in the United States. In every economy, productivity growth is the threshold beyond which economic growth begins to translate into higher employment. The European Commission has calculated that it would take GDP growth of 3-3.5% per annum over a five-year period to make a significant dent in European unemployment. We think Europe will be lucky if it actually achieves 2% annual growth.

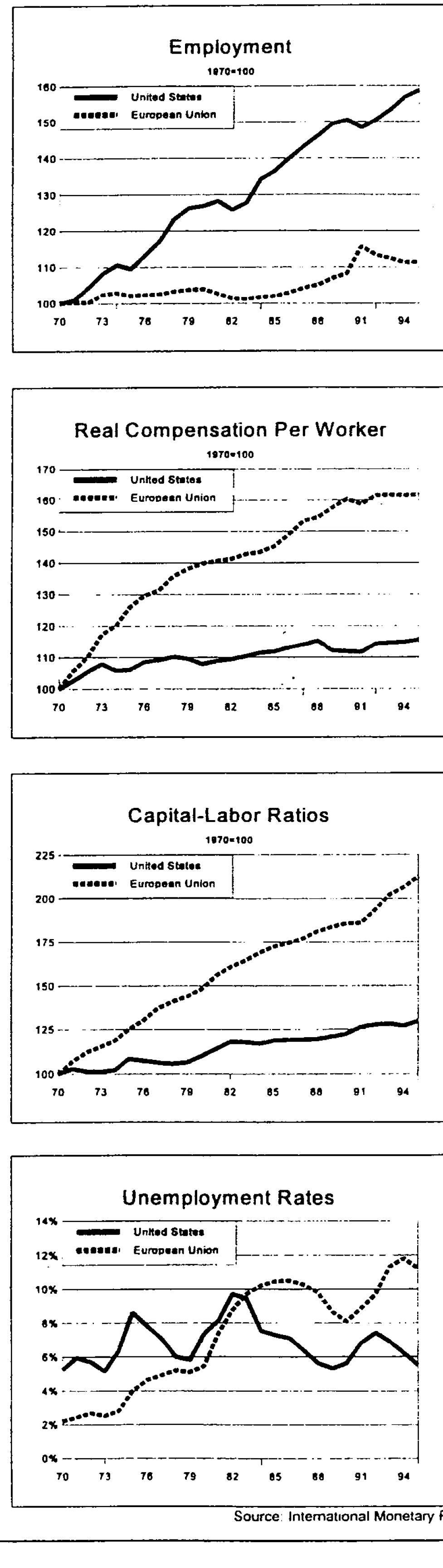
In principle, there are two ways to achieve sustained employment growth. One is capital intensive, the other labor intensive. If the public consensus demands high wages and continuous, large wage increases, this implies capital-intensive growth, with ever higher amounts of capital investment per worker. If the consensus accepts low wages, growth turns labor intensive. Europe chooses the high-wage, capital-intensive pattern; America chooses the low-wage, labor-intensive pattern.

Over the past 25 years, U.S. employment has expanded roughly 60%, in step with the rapid growth in the U.S. labor force. Simultaneously, European employment has risen a bare 11%, with private employment up just 5%. As a result, unemployment has climbed from 2% to 12% today. The dramatic differences between the two economies in wage levels and the effect on employment can be seen in the charts shown here.

In short, raising employment in Europe would require either booming investment in plant and equipment or – as in the United States – a prolonged downward adjustment of wages. The first is not in sight, and the second is not even under serious consideration. There is nothing but empty talk and patchwork. Europe's army of the unemployed is bound to grow and grow.

Yet, at last there has been wage moderation. Over the last three or four years, average nominal wage rates in the EU have risen at a little over 3% per year. Real wage rates have climbed at a bare 0.5% annual rate. Since 1990, the average EU inflation rate has fallen from 6.5% to 2.4%. Given an average productivity growth trend in Europe of 2%, this means unit labor costs for the European economies as a whole have increased at less than a 2% annual rate during this period, versus a U.S. rate of 3%.

Europe & America



Source: International Monetary Fund

Taking everything into consideration – Europe's persistent economic sluggishness, the strong productivity trend, the recent wage moderation and the perilous state of European government finances – we think any further change in inflation rates in Europe can only be to the down side. In the last analysis, all of these influences add up to a deflationary, not an inflationary, undercurrent.

In our view, one of the acid tests of the developing deflationary trend is the general inability of very loose monetary policies to trigger self-accelerating economic recoveries. Both fiscal and monetary policy have lost their former expansive and inflationary leverage on the real economies.

THE U.S. ECONOMY – A DIFFERENT CASE

We have explained that the European economies are sick from overspending and overindebted governments, depressed capital formation and exorbitant wage levels. But how healthy, or sick, by contrast, is the U.S. economy? Pointing to the booming financial markets, low U.S. consumer- and producer-price inflation and the tremendous boom in U.S. job growth, most American economists see nothing but excellent health.

Yet, based on Austrian economic theory (as developed by Ludwig von Mises, Friedrich von Hayek, etc.) we would say the economic and financial situation in the United States is riddled with abnormalities and imbalances. Consider, for example, the consumer borrowing-and-spending spree, the chronically large U.S. trade and current-account deficits, and the persistent huge dollar purchases by foreign central banks.

But by far, the most dangerous U.S. imbalance is the bubble in the financial markets. The proof that it is indeed a bubble can be found in the fact that the huge money inflows supporting it come not from current savings, but from massive credit creation, derivatives leveraging, the carry trade and a head-long flight from cash to securities.

By contrast, America's best-functioning and best-balanced market is its labor market. It delivers virtually full employment with remarkably little wage inflation. But this well-functioning market has a hazardous corollary in the consumer borrowing spree. Given anemic gains in productivity and real wages, the hard-pressed U.S. consumer is sustaining his long-standing spending habits by stampeding further and further into debt.

But, just like government debt, consumer debt is a dead weight that must be serviced out of future income. In one sense, the problem is even more acute, since the much higher interest rates on consumer debt imply much faster debt accumulation from compound interest. As the French economist Jean Baptiste Say observed about government borrowing for the payment of interest: "It is impossible to avoid a precipice when one follows a road that leads nowhere else." Exactly the same logic applies to consumer borrowing.

WORLD RECESSION?

Turning to the short-run outlook for the economies and the markets, we observe that the latter are content with the consensus view that the recent global sluggishness simply is a refreshing pause in an ongoing economic recovery. In the case of the United States, the prevailing optimism hinges critically on the assumption of an imminent return of strong consumer borrowing and spending. Strong income growth, high-riding confidence and big wealth effects from the booming markets are supposed to guarantee this revival. In this view, a rate hike by the Federal Reserve only has been postponed, not cancelled.

The trouble with this perception is that it completely defies the statistical facts. Adjusted for inflation, total U.S. consumer spending has been stagnant since last May, while retail sales have been flat since February. With government spending also flat and the trade balance in rapidly growing deficit, acting as a drag on GDP growth, any recent economic strength has been derived from inventory building and investment in equipment.

Another striking oddity in the consensus forecast for the world economy concerns the outlook for trade. In literally every single country – Europe, Japan, the United States, etc. – policymakers and economists set great hope on a rebound in exports, led by the world economic recovery. Aside from the fact that it simply cannot be possible for every country to enjoy an improving trade balance simultaneously, the actual global trade figures point to exactly the opposite trend: a slowdown in world trade.

A recent report from the World Trade Organization predicts a 5% increase in the volume of global merchandise exports this year, following an 8% rise last year, and 10% in 1994. Only last March, the WTO's forecast called for 7% export growth in 1996. Reduced consumer demand in Western Europe and North America is mentioned as the chief cause of this downward revision. Recent national trade data also show a progressive weakening of exports.

Given the unusual sluggishness of the global economic recovery since 1992-93, everybody is waiting for more strength to materialize. We, on the other hand, begin to wonder whether the best part of the current business cycle may not already be behind us.

IF THE FED CUTS RATES

We wouldn't insist on forecasting a recession next year, but we think it safe to say that economic growth generally will be a serious disappointment. How will this impact the financial markets? We read jubilant predictions that lower U.S. interest rates will stoke still more bullishness, not only in the bond markets but also in the stock markets, driving valuation levels to new highs.

We, on the other hand, think that strong disappointment about economic growth next year will come as a shock to everybody, particularly in the United States, where expectations are highest. For the bond markets, this unquestionably will be bullish, although we remain quite ill at ease about the rampant leveraged speculation in that market. Still, with continuing or even added monetary ease, it's difficult to see what will prick that particular bubble.

Foremost in our mind are the probable effects of future rate cuts by the Fed. Depending on the size of those cuts, we expect a shift in the financing of leveraged U.S. Treasury positions away from cheap yen, Swiss francs or DM and into dollars. This would have the great advantage of eliminating any exchange-rate risk from such deals. Of course, such a development also would weaken the dollar.

In the U.S. case, a further big unknown for the dollar and the bond market are the abnormally high purchases of dollars and Treasury bonds by foreign central banks, now running well over $100 billion annually. Far from slowing, these purchases in recent months have set a new record: $69.5 billion since the middle of the year. With these purchases, foreign central banks have played a crucial role in funding both the U.S. federal deficit and the current-account deficit. In the three months ending in September, the latter hit a quarterly record of $48 billion, or $192 billion at an annual rate. Merchandise trade was $51.6 billion, or $206.4 billion at an annual rate, in the red.

In the last analysis, these persistent, huge dollar and bond purchases by foreign central banks really are the indispensable prop for the dollar and, by extension, for the global financial markets. In their absence, a collapsing dollar long ago would have compelled the Fed to drastically tighten monetary policy, instantly ending the global financial boom.

Will these purchases continue on their current vast scale? We suspect they will. Confronted with weakening economies and sharply lower exports, the leaders of the creditor countries are more desperate than ever to prevent an appreciation of their currencies against the dollar. But we still believe that investors – particularly those tempted by the yields now available in the U.S. bond market – should keep in mind the utter abnormality of the artificial capital flows now financing the U.S. budget and current-account deficits.

WHY SHOULD MR. GREENSPAN WORRY?

Obviously, Federal Reserve Chairman Alan Greenspan's expression of concern about potentially "irrational exuberance" in the financial markets both surprised and irritated Wall Street. Why, outraged speculators and traders asked, should a central bank worry at all about financial asset prices, as long as inflation rates remain low?

To our readers, the answer should be obvious. The worst speculative bubbles in history, those followed by the most devastating crashes, have taken place against a backdrop of low consumer- and producer-price inflation. We refer primarily to the U.S. stock-market bubble of the late 1920s, and the Japanese bubble of the late 1980s.

Yet, it also is a historical fact that central banks generally have ignored inflationary asset bubbles in setting monetary policy, with the sole exception of the Bank of Japan, which hiked interest rates in late 1989 with the declared intention of puncturing the speculative bubble in land and stock prices. However, the BoJ was far too late to prevent a disastrous bust, which depressed the whole economy with its massive liquidity and wealth destruction.

In the late 1980s, a number of other countries also experienced rampant asset inflation, concentrated in commercial and residential real estate. But the present bubble of the 1990s is unique in three respects. First, it is exclusively in financial assets, primarily bonds and stocks. Secondly, it is global in scope. Thirdly, it mainly has been fueled by financial leveraging, rather than accelerating money growth.

The central aspect of every asset bubble is its liquidity implications. The boom is the phase marked by a general rush out of money, owned or borrowed, and into certain assets. The bust is the phase in which more and more asset holders want to lock in their profits and rebuild their depleted liquidity. As the second phase is implied by the first, boom and bust are in fact inseparable. That also is the reason why central banks ought to be on the alert against allowing the creation of a bubble in the first place.

The collapse of any bubble is an inevitable, compelling event, because eventually there comes a point where speculators and investors realize, gradually or suddenly, that the market will not go higher. It is time to withdraw. But the trouble is that collectively they are unable to do so. Each individual seller can liquidate his asset holdings only if somebody else is willing to step into his place. For every dollar that gets out another must enter. If there is a general pressure to sell, the main effect is plunging asset prices, meaning plunging overall liquidity. To quote von Mises: "There is no means of avoiding these secondary consequences of the preceding boom."

In our view, there is an immense potential for a crash, particularly in the United States. We see two main reasons for this. First, stock valuations are at all-time extremes. Second, the overall liquidity ratio, as measured by the ratio of the money stock to GDP or income, has been in a prolonged, sharp decline, reflecting an ever lower liquidity preference on the part of investors. Neither of the two trends can go on indefinitely.

As we have pointed out before, one of the greatest fallacies in the prevailing perception about this global boom is the notion that it has been fueled by vast excess liquidity. There is even some anxiety that this excess one day will spill over into the real economy, boosting consumer- and producer-price inflation. This will never happen. As previously explained, all the money heretofore invested in the bubble is locked in. Any sales can only take place at sharply falling prices – with deflationary effects on the entire economy.

FINANCIAL CATCH-AS-CATCH-CAN

If Mr. Greenspan, with his recent remarks about the possibility of "irrational exuberance," wanted to dampen the hectic state of the financial markets, he definitely achieved the opposite. To begin with, these markets are dominated not by emotional investors, but rather by highly-leveraged speculators, derivatives strategists and

performance-chasing money managers. To these players, market volatility only provides additional opportunities for aggressive trading and quick profits.

Instead of calming markets, Mr. Greenspan raised the stakes. Because his comments and the market's instant retreat triggered heavy hedging and derivatives trading to protect against future losses, he actually added fuel to the "triple witching" melt-up of December 19, the day before the expiration of December stock and stock-index futures and options contracts.

Mr. Greenspan's comments, made the evening of December 5, came at a time when players were poorly positioned for a sharp decline. The next morning, traders faced an S&P 500 futures contract already halted after trading limit down overnight. Stocks opened with large losses and put options had large premiums. The trade *du jour* for the speculators and hedgers who missed the market's initial drop became selling December call options, set to expire in two weeks, and pocketing the large premiums. There also was considerable short selling, especially in the large-cap technology stocks, by managers of Wall Street derivatives operations. They also had been caught poorly positioned by Greenspan's remarks, forcing them into a frantic attempt to hedge their increasing exposure in a falling market.

In the end, the stock market was left precariously balanced between heavy derivatives bets on a falling and rebounding market, implying a forceful reaction either way. As fate would have it, a meager rebound in bonds and a very weak stock market in Japan – ameliorating the perceived risk of higher Japanese interest rates for the huge yen carry trade – tilted the scales in favor of the bulls.

Between the close on Monday, December 16 and the highs set during the derivative-induced chaotic opening on triple-witching Friday, December 20, the Dow gained 281 points, or 4.5%, while the Nasdaq 100 rose 49 points, or 6%. Further confirming the leading role of derivatives, combined NYSE and Nasdaq volume on that Friday reached 1.4 billion shares, of which an amazing 450 million shares were traded in just the first 30 minutes.

Obviously, this type of trading has absolutely nothing to do with economic fundamentals, let alone company-specific developments. This is reckless, highly leveraged speculation, where prices often are determined by distressed short covering, with little or no relevance to the actual supply and demand of the underlying assets. In this environment, company specifics, which in many cases clearly are deteriorating, easily have been ignored.

The current, still bullish mood in the market was captured clearly with the recent quarterly earnings report from Micron Technology, which disclosed dramatically deteriorating profits and a year-over-year revenue decline of 39%. However, the headline put on the story by *Bloomberg Business News* read: "Micron Says First Quarter Earnings Fell a Better-Than-Expected 95%." Ignoring continuing, unmistakable deterioration in business conditions, the Philadelphia Semiconductor Index has gained over 75% since its July lows.

To us, it looks more like a financial catch-as-catch-can than an investment market. But it is difficult to say what will stop it as long as foreign central banks continue to readily accommodate American inflation. All we can say is: Don't be fooled by Wall Street into believing that all these are signs of economic and financial health.

CONCLUSIONS

Our basic assumption for 1997 is that both the world economy and world trade will slow further. Oddly, official forecasts, including the IMF's recent World Economic Outlook, assume a resumption of stronger growth, chiefly in Europe. Easier money and currency depreciation are to be the supposed causes of this revival. To quote the IMF: "The projected strengthening of growth in Europe will facilitate fiscal consolidation, and lessen uncertainties about the EMU timetable."

To us, just the opposite appears virtually certain. Disappointing growth in Europe generally will spoil the expected fulfillment of the Maastricht deficit criteria and increase the uncertainties about EMU. Owing to a ruling by the German Constitutional Court, and to hostile public opinion in Germany, Chancellor Kohl will be forced to insist on the strict application of the Maastricht conditions.

What the EU's recently concluded Dublin summit revealed is a fundamental discordance and underlying mistrust between Germany and France regarding their perceptions of a single currency for Europe. The French government has capitulated to strikes and protests and looks for easier money and currency deflation as the cures for deflation and austerity. Conveniently ignoring their own misguided policies, French policymakers choose the Bundesbank as their scapegoat.

In Germany, on the other hand, all the blame for Europe's economic malaise is put on the tax, welfare and wage excesses perpetrated by governments, trade unions and business leaders. Criticism of the Bundesbank is virtually nonexistent, given a general conviction that loose money can only worsen these maladjustments. That, in a nutshell, is the difference between the French and Germany currency cultures.

As to the global economy, it will continue to languish. The salient point to see is that this protracted global economic sluggishness is overwhelmingly of a structural, not a cyclical, nature. Capital consumption and the upward spiral of compound interest are taking their long-term toll as depressants on economic growth. To reinvigorate the real economies, the excesses and maladjustments from past policies first of all would have to be stopped and unwound. We don't see this happening. All governments are fighting a losing battle with the compounding interest on their debts.

Desperate attempts to reflate economies with loose money continue to have very little effect. Instead, loose money stokes ever greater speculative excesses in the financial markets, carrying asset prices to levels ever further beyond any reasonable relationship to corresponding fundamental values. As the global economy will remain too weak to generate any inflationary pressures, we see no end to what basically is a deflationary scenario. What's more, we see the risks being on the side of a more serious deflation.

In this environment there seems to be no limit to the speculative excesses in the financial markets. Still, every bubble is born doomed, and when this one bursts, creeping deflation will turn into a savage deflationary spiral. To be sure, Wall Street in general and U.S. stocks in particular are most exposed.

Notwithstanding our pessimistic outlook, we would like to take this opportunity to thank our loyal readers for their support and encouragement in 1996, and to extend our hopes for a happy and prosperous new year.

THE RICHEBÄCHER LETTER

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